

HOUSE BILL REPORT

ESSB 6032

As Reported by House Committee On:
Financial Institutions & Insurance

Title: An act relating to exchange facilitators.

Brief Description: Concerning exchange facilitators.

Sponsors: Senate Committee on Financial Institutions, Housing & Insurance (originally sponsored by Senators Berkey and Hobbs).

Brief History:

Committee Activity:

Financial Institutions & Insurance: 3/19/09 [DP].

Brief Summary of Engrossed Substitute Bill

- Affects specific persons who facilitate the exchange of property for tax purposes.
- Provides certain financial security standards.
- Establishes prohibited practices.

HOUSE COMMITTEE ON FINANCIAL INSTITUTIONS & INSURANCE

Majority Report: Do pass. Signed by 11 members: Representatives Kirby, Chair; Kelley, Vice Chair; Bailey, Ranking Minority Member; Parker, Assistant Ranking Minority Member; Hurst, McCoy, Nelson, Roach, Rodne, Santos and Simpson.

Staff: Jon Hedegard (786-7127)

Background:

The Internal Revenue Code (26 U.S.C. 1031) (Code) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business, or for investment. A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more "like-kind" replacement properties. This enables a property owner to defer the payment of federal income taxes on the transaction. If

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the replacement property is sold (as opposed to making another qualified exchange), the property owner must pay tax on the original deferred gain plus any additional gain realized since the purchase of the replacement property. Section 1031 of the Code does not apply to exchanges of inventory, stocks, bonds, notes, other securities or evidence of indebtedness, or certain other assets.

There are Code provisions regarding the exchange process. If these provisions are not met, the exchange does not qualify to defer the taxation. There are no other federal or state laws specific to the exchange facilitators (also known as "qualified intermediaries" under federal law) required to facilitate the exchange.

Summary of Bill:

Definitions.

Six definitions are created in the bill.

The exchange facilitator business must be under the direct management of an officer or an employee who is either:

- an attorney or certified public accountant admitted to practice in any state in the United States or territory; or
- has passed a test specific to the subject matter of exchange.

A facilitator may not sue their clients for compensation unless the facilitator proves their compliance with all the requirements in this act.

Financial Security - Fidelity Bond.

Each person in the exchange facilitator business (facilitator) must:

- maintain a fidelity bond or bonds in an amount of not less than \$1 million; or
- deposit an amount of cash and securities or irrevocable letters of credit equivalent to \$1 million into an interest-bearing deposit or money market account at a financial institution of the facilitator's choice. The interest accrues to the facilitator.

Financial Security - Insurance.

Each facilitator must:

- maintain a policy of errors and omissions of not less than \$250,000; or
- deposit an amount of cash and securities or irrevocable letters of credit equivalent to \$250,000 into an interest-bearing deposit or money market account at a financial institution of the facilitator's choice. The interest accrues to the facilitator.

Compliance with Financial Security Requirements and Claims Against the Financial Security.

A facilitator must demonstrate compliance with the fidelity bond and insurance requirements upon the request of a current or prospective client. Any person claiming to have sustained damage by reason of the failure of a facilitator to comply with this chapter may seek to recover damages from the facilitator's insurance, fidelity bond or bonds or the deposits, or the letters of credit maintained in lieu of the insurance, bond, or bonds.

Custodian of Funds.

A facilitator must act as a custodian for all exchange funds, property, and other items received from the client (except the facilitator's compensation). The exchange funds must be held in a manner that provides liquidity and preserves principal. An exchange facilitator must provide the client with written notification of how the funds are invested or deposited. If invested, the facilitator must invest the exchange funds in investments that meet a prudent investor standard and that satisfy the goals of liquidity and preservation of principal. A prudent investor standard is violated if any of the following occurs:

- exchange funds are knowingly commingled by the facilitator with the operating accounts of the facilitator;
- exchange funds are loaned or otherwise transferred to any person or entity, other than a financial institution, that is affiliated with or related to the facilitator. This does not apply to the transfer of funds from a facilitator to an exchange accommodation titleholder under an exchange contract; or
- exchange funds are invested in a manner that does not provide sufficient liquidity or there is a loss of principal. This standard is not violated if the insufficient liquidity or loss of principal is due to events beyond the control of the facilitator or beyond the ability of facilitator to predict. It is also not violated if the investment was made at the specific request of the client.

Prohibited Practices.

A facilitator must not, knowingly or with criminal negligence, commit specified prohibited practices related to a like-kind transaction. These prohibited practices include:

- making false, deceptive, or misleading material statements;
- making deceptive or misleading material statements in advertising;
- engaging in unfair or deceptive acts;
- commingling of funds, except as allowed;
- loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping exchange funds under a client's name;
- a material failure to fulfill contractual duties to deliver funds or property unless the failure is due to a cause that is beyond the control of the facilitator;
- a failure to provide required disclosures;
- negligently making a false statement or willfully omitting a material fact in a report or investigation; and
- committing certain crimes.

Accounts.

All accounts above \$500,000 must be placed in a separately identified account and the client must receive the earnings related to that account. Accounts of less than \$500,000 may be pooled with other client accounts if the client agrees, in writing, to the pooling. If the client does not agree, the funds must be placed in a separately identified account.

Criminal Penalties.

It is a class B felony to commit certain prohibited practices related to a like-kind transaction. These prohibited practices include:

- making false, deceptive, or misleading material statements;

- making deceptive or misleading material statements in advertising;
- engaging in unfair or deceptive acts;
- commingling of funds, except as allowed;
- loaning or transferring money to a person or entity affiliated with the facilitator, except as allowed;
- keeping exchange funds under a client's name; and
- a material failure to fulfill contractual duties to deliver funds or property unless the failure is due to a cause that is beyond the control of the facilitator.

It is a misdemeanor to commit certain prohibited practices related to a like-kind transaction. These prohibited practices include:

- failing to make disclosures required by any applicable state or federal law; or
- negligently making any false statement or knowingly and willfully make any omission of material fact in connection with any reports filed by an exchange facilitator or in connection with any investigation conducted by the Department of Financial Institutions (DFI).

Consumer Protection Act.

Violations of the chapter are violations under the Consumer Protection Act.

Department of Financial Institutions Report.

Facilitators must file information with the DFI by December 31, 2009. The information is exempt from public disclosure, and will be compiled by the DFI for reporting to the Legislature.

Appropriation: None.

Fiscal Note: Available.

Effective Date: The bill takes effect 90 days after adjournment of the session in which the bill is passed.

Staff Summary of Public Testimony:

(In support) Representative Kelley and staff must be thanked for all of the hard work that went into this bill. The House bill is identical to the Senate bill. It is the House bill that should be the bill signed into law. This bill adds valuable consumer protections. One key provision is the segregation of accounts. This eliminates one area for possible fraud. This bill is the same that passed off the House floor. This provides good consumer protections. This bill includes many deterrents to wrongful behavior, including: prohibited practices; violations of the act are violations of the CPA; and there are criminal penalties for violations.

(Opposed) None.

Persons Testifying: Senator Berkey, prime sponsor; and Dennis Helmick and Tom Oldfield, Federation of Exchange Accommodators.

Persons Signed In To Testify But Not Testifying: None.